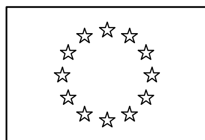

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Technical Annex to the

CONVERGENCE REPORT 2006 ON SLOVENIA

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European Economy

2006 Convergence Report on Slovenia – Technical annex

A Commission services working paper

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Abbreviations and symbols used

Member States

BE	Belgium
CZ	Czech Republic
DK	Denmark
DE	Germany
EE	Estonia
EL	Greece
ES	Spain
FR	France
IE	Ireland
IT	Italy
CY	Cyprus
LV	Latvia
LT	Lithuania
LU	Luxembourg
HU	Hungary
MT	Malta
NL	The Netherlands
AT	Austria
PL	Poland
PT	Portugal
SI	Slovenia
SK	Slovakia
FI	Finland
SE	Sweden
UK	United Kingdom

EU-10 European Union Member States that joined the EU on 1 May 2004 (CZ, EE, CY, LT, LV,HU, MT, PL, SI, SK)

EU-12 European Union Member States having adopted the single currency (BE, DE, EL, ES, FR, IE, IT, LU, NL, AT, PT, FI)

EU-15 European Union, 15 Member States before 1 May 2004 (EUR-12 plus DK, SE and UK)

EU-25 European Union, 25 Member States

Currencies

EUR euro

ECU European currency unit

DEM German mark

SIT Slovenian tolar

USD US dollar

Other abbreviations

CPI consumer price index

ECB European Central Bank

EMI European Monetary Institute

EMU economic and monetary union

ERM II exchange rate mechanism II

ESCB European System of Central Banks

Eurostat Statistical Office of the European Communities

FDI foreign direct investment

GDP gross domestic product

GFCF gross fixed capital formation

HICP harmonised index of consumer prices

MTO medium-term objective

VAT value added tax

1. INTRODUCTION

1.1. Role of the report

The euro was introduced on 1 January 1999, following several years of successful adjustment efforts by the Member States to achieve a high degree of sustainable convergence. The decision[1] by the Council (meeting in the composition of the Heads of State or Government) on 3 May 1998 in Brussels on the eleven Member States deemed ready to participate in the single currency had, in accordance with the Treaty (Article 121(4)), been prepared by the Ecofin Council on a recommendation from the Commission. The decision was based on the two convergence reports made by the Commission[2] and the European Monetary Institute (EMI).[3] These reports, prepared in accordance with Article 121(1) of the Treaty, examined in considerable detail whether the Member States satisfied the convergence criteria and met the legal requirements.

Those Member States which are assessed as not fulfilling the necessary conditions for the adoption of the single currency are referred to as "Member States with a derogation". Article 122(2) of the Treaty lays down provisions and procedures for examining the situation of Member States with a derogation *(Box 1.1)*. At least once every two years, or at the request of a Member State with a derogation, the Commission and the European Central Bank (ECB) are required to prepare convergence reports on such Member States.

Box 1.1: Article 122(2) of the Treaty

"At least once every two years, or at the request of a Member State with a derogation, the Commission and the ECB shall report to the Council in accordance with the procedure laid down in Article 121(1). After consulting the European Parliament and after discussion in the Council, meeting in the composition of the Heads of State or Government, the Council shall, acting by a qualified majority on a proposal from the Commission, decide which Member States with a derogation fulfil the necessary conditions on the basis of the criteria set out in Article 121(1), and abrogate the derogations of the Member States concerned."

Denmark and the United Kingdom negotiated opt-out arrangements before the adoption of the Maastricht Treaty[4] and do not participate in the third stage of EMU. Until these Member States indicate that they wish to participate in the third stage and join the single currency, they are not the subject of an assessment by the Council as to whether they fulfil the necessary conditions.

Greece submitted a request on 9 March 2000 for its convergence situation to be re-examined. The Ecofin Council adopted the decision[5] that Greece fulfilled the necessary conditions for adoption of the single currency on 19 June 2000. The decision was taken on the basis of a proposal from the Commission and having regard to the discussion of the Council, meeting in the composition of Heads of State or Government. The decision was based on two convergence reports made by the Commission[6] and the ECB[7], which covered both Greece and Sweden. Greece adopted the single currency with effect from 1 January 2001. Sweden was assessed in 2000 as not fulfilling the necessary conditions for the adoption of the single currency.

In 2002, the convergence assessment covered only Sweden and concluded that Sweden was not fulfilling

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1 OJ L 139, 11.5.1998, pp. 30-35.

2 Report on progress towards convergence and recommendation with a view to the transition to the third stage of economic and monetary union, COM(1998)1999 final, 25 March 1998.

3 European Monetary Institute, Convergence Report, March 1998.

4 Protocol (No 26) on certain provisions relating to Denmark, Protocol (No 25) on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland

5 OJ L 167, 7.7.2000, pp. 19-21.

6 European Commission, Convergence Report 2000, COM(2000) 277 final, 3 May 2000.

7 European Central Bank, Convergence Report 2000, May 2000.

the necessary conditions for the adoption of the single currency and continued to be referred to as a "Member State with a derogation".[8]

In 2004, Sweden was examined together with the ten countries that joined the EU on 1 May 2004. In accordance with Article 4 of the Act of Accession, the ten countries became upon entry “Member States with a derogation”. Although the maximum period referred to in Article 122(2) of the Treaty had not elapsed for these countries in 2004, the re-assessment of Sweden was seized as an opportunity to analyse also the state of convergence in the new Member States. None of the assessed countries was considered to have fulfilled the necessary conditions for the adoption of the single currency.[9]

In 2006, two years will have elapsed since the last reports were made. The Commission and the ECB envisage to prepare a comprehensive report in October 2006, assessing progress with convergence for all Member States with a derogation. On 2 March, Slovenia submitted a request for an earlier convergence assessment. As a response to this request, the Commission and the ECB prepared convergence reports for Slovenia.

This Commission services working paper is a technical annex to the convergence report on Slovenia and includes a detailed assessment of the progress with convergence. The remainder of the first chapter presents the methodology used for application of the assessment criteria and an overview of the main findings. Chapters 2 to 7 examine fulfilment of each of the convergence criteria and other requirements in the order as they appear in Article 121(1). The cut-off date for the statistical data included in this convergence report was 28 April 2006.

1.2. Application of the criteria

In accordance with Article 121(1), the convergence reports shall examine the compatibility of national legislation with the Treaty and the Statute of the European System of Central Banks (ESCB) and of the European Central Bank. The reports shall also examine the achievement of a high degree of sustainable convergence by reference to the fulfilment of the four convergence criteria dealing with price stability, the government budgetary position, exchange rate stability and long-term interest rates as well as some additional factors *(Box 1.2)*. The four convergence criteria have been developed further in a Protocol annexed to the Treaty (Protocol No 21 on the convergence criteria). A more detailed explanation of how to interpret and apply the criteria was provided in the convergence reports issued up to present.

8 European Commission, Convergence Report 2002, COM(2002) 243 final, 22 May 2002; and European Central Bank, Convergence Report 2002, May 2002.

9 European Commission, Convergence Report 2004, COM(2004) 690 final, 20 October 2004; and European Central Bank, Convergence Report 2004, October 2004.

Box 1.2: Article 121(1) of the Treaty

"1. The Commission and the EMI shall report to the Council on the progress made in the fulfilment by the Member States of their obligations regarding the achievement of economic and monetary union. These reports shall include an examination of the compatibility between each Member State's national legislation, including the statutes of its national central bank, and Articles 108 and 109 of this Treaty and the Statute of the ESCB. The reports shall also examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the following criteria:

– the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability;

– the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 104(6);

– the observance of the normal fluctuation margins provided for by the exchange rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State;

– the durability of convergence achieved by the Member State and of its participation in the exchange rate mechanism of the European Monetary System being reflected in the long term interest rate levels.

The four criteria mentioned in this paragraph and the relevant periods over which they are to be respected are developed further in a Protocol annexed to this Treaty. The reports of the Commission and the EMI shall also take account of the development of the ECU, the results of the integration of markets, the situation and development of the balances of payments on current account and an examination of the development of unit labour costs and other price indices."

Compatibility of legislation

In accordance with Article 121(1) of the Treaty, the legal examination includes an assessment of compatibility between a Member State's legislation, including the statute of its national central bank, and Articles 108 and 109 of the Treaty and the Statute of the ESCB/ECB. This assessment mainly covers three areas. First, the objectives of the national central bank must be examined, in order to verify their compatibility with the objectives of the ESCB as formulated in Article 105(1) and Article 2 of the Statute of the ESCB/ECB. The ESCB's primary objective is to maintain price stability. Without prejudice to this objective, it shall support the general economic policies in the Community. Second, the independence of the national central bank and of the members of its decision-making bodies (Article 108) must be assessed. This assessment covers all issues linked to a National central bank's institutional and financial independence and to the personal independence of the members of its decision-making bodies. Third, the integration of the national central bank into the ESCB has to be examined, in order to ensure that the national central bank acts in accordance with the ECB's guidelines and instructions once the country concerned has adopted the single currency.

Price stability

The price stability criterion is defined in the first indent of Article 121(1) of the Treaty: "*the achievement of a high degree of price stability […] will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability*".

Article 1 of the Protocol on the convergence criteria further stipulates that "the criterion on price stability […] shall mean that a Member State *has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best-performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions*".

Since national consumer price indices (CPIs) diverge substantially in terms of concepts, methods and practices, they do not constitute the appropriate means to meet the Treaty requirement that inflation must be measured on a comparable basis. To this end, the Council adopted on 23 October 1995 a framework regulation[10] setting the legal basis for the establishment of a harmonised methodology for compiling consumer price indices in the Member States. This process resulted in the production of the *Harmonised Indices of Consumer Prices (HICPs)*, which have been used for assessing the fulfilment of the price stability criterion. Until December 2005, HICP series had been based on 1996 as the reference period. A Commission Regulation (EC) No 1708/2005[11] provided the basis for a change of the HICP index base reference period from 1996=100 to 2005=100.

As has been the case in past convergence reports, a Member State's *average rate of inflation* is measured by the percentage change in the arithmetic average of the last 12 monthly indices relative to the arithmetic average of the 12 monthly indices of the previous period. The *reference value* is calculated as the arithmetic average of the average rate of inflation of the three best-performing Member States in terms of price stability plus 1.5 percentage points.

Over the 12 month period covering April 2005-March 2006, the three best-performing Member States in terms of price stability were Sweden (0.9 percent),

[10] Council Regulation (EC) No 2494/95 of 23 October 1995 concerning harmonised indices of consumer prices (OJ L 257, 27.10.1995, pp. 1-4)

[11] Commission Regulation (EC) No 1708/2005 of 19 October 2005 laying down detailed rules for the implementation of Council Regulation (EC) No 2494/95 as regards the common index reference period for the harmonised index of consumer prices, and amending Regulation (EC) No 2214/96.

Finland (1.0 percent) and Poland (1.5 percent) yielding a reference value of 2.6 percent.[12] Over the period January 1999 to March 2006, the reference value – based on the EU-15 until April 2004 and the EU-25 afterwards – fell to a low of 1.8 percent in July 1999 and peaked between February and April 2002 at 3.3 percent. In September 2004, the reference value fell for the first time below the euro area average when Lithuania entered the basket of three best performers.

The Protocol on the convergence criteria not only requires Member States to have achieved a high degree of price stability but also calls for a price performance that is sustainable. The requirement of *sustainability* aims at ensuring that the degree of price stability and inflation convergence achieved in previous years will be maintained after adoption of the euro. This implies that the satisfactory inflation performance must essentially be due to the adequate behaviour of input costs and other factors influencing price developments in a structural manner, rather than reflecting the influence of temporary factors. Therefore, this Working Paper studies also developments in unit labour costs as a result of trends in labour productivity and nominal compensation per head. Also, developments in import prices are examined to assess whether and how external price developments have impacted on domestic inflation.

[12] The reference values used in the 1998, 2000, 2002 and 2004 Convergence Reports were 2.7, 2.4, 3.3 and 2.4 percent, respectively. The ordering of best performers is based on unrounded data.

Table 1.1.

Evolution of the inflation reference value [1)]

	Three best performers [2)]	Reference value [3)]	Euro area average inflation rate [2)]
January 04	DE, FI, AT	2.7	2.1
February 04	DE, FI, AT	2.6	2.0
March 04	FI, DE, AT	2.5	1.9
April 04	FI, DE, AT	2.5	1.9
May 04	FI, CZ, DE	2.5	2.0
June 04	FI, DK, CZ	2.5	2.0
July 04	FI, DK, UK	2.4	2.1
August 04	FI, DK, SE	2.4	2.1
September 04	LT, FI, DK	1.9	2.1
October 04	FI, LT, DK	2.1	2.1
November 04	FI, LT, DK	2.1	2.1
December 04	FI, DK, SE	2.2	2.1
January 05	FI, DK, SE	2.2	2.1
February 05	FI, DK, SE	2.1	2.2
March 05	FI, DK, SE	2.2	2.2
April 05	FI, SE, DK	2.3	2.2
May 05	FI, SE, DK	2.3	2.2
June 05	FI, SE, DK	2.3	2.2
July 05	FI, SE, DK	2.3	2.1
August 05	FI, SE, DK	2.4	2.1
September 05	FI, SE, NL	2.4	2.2
October 05	FI, SE, NL	2.4	2.2
November 05	FI, SE, NL	2.5	2.2
December 05	FI, SE, NL	2.5	2.2
January 06	SE, FI, NL	2.6	2.2
February 06	SE, FI, NL	2.6	2.2
March 06	SE, FI, PL	2.6	2.3

1) EU-15 until April 2004; EU-25 from May 2004 onwards.

2) Measured by the percentage change in the arthmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices of the previous period.

3) Unweighted arithmetic average of the three best performers in terms of inflation plus 1.5 pecentage points.

Source: Commission services

Government budgetary position

The convergence criterion dealing with the government budgetary position is defined in the second indent of Article 121(1) of the Treaty as "*the sustainability of the government financial position: this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 104(6)*". Furthermore, Article 2 of the Protocol on the convergence criteria states that this criterion means that "*at the time of the examination the Member State is not the subject of a Council decision under Article 104(6) of this Treaty that an excessive deficit exists*".

The convergence assessment in the budgetary area is thus directly linked to the excessive deficit procedure which is specified in Article 104 of the Treaty and further clarified in the Stability and Growth Pact.[13] The existence of an excessive deficit is determined in relation to the two criteria for budgetary discipline set in Article 104(2), namely on the government deficit and the government debt. Failure by a Member State to fulfil the requirements under either of these criteria can lead to a decision by the Council on the existence of an excessive deficit, in which case the Member State concerned does not comply with the budgetary convergence criterion.[14]

Exchange rates

The Treaty refers to the exchange rate criterion in the third indent of Article 121 as *"the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State".*

Article 3 of the Protocol on the convergence criteria stipulates: *"The criterion on participation in the exchange rate mechanism of the European Monetary System (...) shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period".* Based on the Council Resolution on the establishment of the ERM II[15], the European Monetary System has been replaced by the exchange-rate mechanism II upon the introduction of the euro, and the euro has become the centre of the mechanism.

As in previous reports, the assessment of this criterion verifies the participation in ERM II and examines exchange rate behaviour within the mechanism. The relevant period for assessing exchange rate stability in this Working Paper is May 2004 to April 2006.

Long-term interest rates

The fourth indent of Article 121(1) of the Treaty requires *"the durability of convergence achieved by the Member State and of its participation in the exchange rate mechanism of the European Monetary System being reflected in the long-term interest rate levels".* Article 4 of the Protocol on the convergence

[13] Information regarding the excessive deficit procedure and its application to different Member States since 2002 can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/edp_en.htm.

[14] The definition of the general government deficit used in this report is in accordance with the excessive deficit procedure, as was the case in previous convergence reports. In particular, interest expenditure, total expenditure and the overall balance include net streams of interest expenditure resulting from swaps arrangements and forward rate agreements. Government debt is general government consolidated gross debt at nominal value.

[15] 97/C 236/03 of 16 June 1997, OJ C 236, 2.8.1997, p.5.

criteria further stipulates that *"the criterion on the convergence of interest rates (...) shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best-performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions".*

For the assessment of the criterion on the convergence of interest rates, yields on benchmark 10-year bonds have been taken, using an average rate over the latest 12 months. The reference value is calculated as the simple average of the average long-term interest rates of the three best-performing Member States in terms of price stability plus 2 percentage points. In March 2006, the reference value, derived from the average interest rate in Sweden (3.3 percent), Finland (3.3 percent), and Poland (5.0 percent), was 5.9 percent.

Additional factors

The Treaty in Article 121 also requires an examination of other factors relevant to economic integration and convergence. These additional factors include the results of financial and product market integration and the development of the balance of payments. The examination of the development of unit labour costs and other price indices, which is also prescribed by Article 121 of the Treaty, is covered in the chapter on price stability.

The additional factors are an important indicator that the integration of a Member State into the euro area would proceed without major difficulties. As regards *integration of financial markets*, focus is on compliance with the acquis communautaire in respect of the financial sector, on main characteristics, structures and trends of the financial sector and on progress in financial integration. *Integration of product markets* is assessed through trade, foreign direct investment and merger and acquisition activity and a smooth functioning of the internal market. Finally, the situation and development of *the current account of the balance of payments* is examined to ensure that the Member States joining the euro area are not subject to unsustainable external imbalances leading to high vulnerability to shocks.

2. LEGAL COMPATIBILITY

2.1. Situation in the 2004 Convergence Report

In its 2004 Convergence Report, the Commission concluded that, as regards central bank integration into the ESCB at the time of euro adoption, legislation in Slovenia, in particular the Bank of Slovenia Act (BoSA), was not fully compatible with Article 109 of the EC Treaty and the ESCB/ECB Statute. In addition, the correction of some residual imperfections was recommended, in particular with respect to the Bank's objectives as well as in the field of personal and institutional independence.

The incompatibilities in the area of integration into the ESCB were linked to the holding and managing of foreign reserves; the right to authorise the issue of banknotes and the volume of coins; and the monetary functions, operations and instruments of the ESCB.

An imperfection subsisted as regards the Bank's objectives, as its secondary objective to support the general economic policy needed to reflect the wording of Article 105(1) EC more closely, while its third objective – safeguarding financial stability – should be subordinated to the second one.

Further imperfections subsisted as regards the bank's institutional and personal independence. The nature of the Government's involvement with respect to the management of foreign exchange assets required further clarification, while the grounds for dismissal of the members of the Governing Board of the Bank of Slovenia needed to be aligned with those mentioned under Article 14(2) of the ESCB/ECB Statute.

2.2. Current legal situation

After adoption by the Board of the Bank of Slovenia and approval by the Ministry of Finance, the draft Act amending the Bank of Slovenia Act (BoSA) was submitted to the ECB for consultation pursuant to Article 105(4) of the EC Treaty and the ECB delivered its Opinion on 13 March 2006 (CON/2006/17). On 16 March 2006, the Government submitted a revised draft Act to the Parliament for adoption. The revised Act was adopted without major changes by Slovenia's Parliament on 30 March 2006.

Integration into the ESCB

The incompatibilities raised in the 2004 Convergence Report have been removed. The Act amending the Bank of Slovenia Act removes Article 58(2) BoSA in its present form, while Articles 8, 9 and 45 BoSA will cease to apply from the day of the introduction of the euro in Slovenia. A new Article 61(2) BoSA clarifies that the Bank of Slovenia's competences in the area of monetary functions, operations and instruments as referred to in Articles 15-20 BoSA will be transferred to the ESCB as from the date of the introduction of the euro.

Objectives

The objectives of the Bank of Slovenia have been amended and reflect the wording of Article 105(1) of the EC Treaty more accurately. Moreover, the secondary objective (supporting the general economic policy in accordance with the objectives set in the EC Treaty) is now clearly subordinated to the primary one (price stability). However, the third objective (strive for financial stability, applying the principles of an open market economy and free competition) is not clearly subordinated to the primary and secondary ones.

Independence

The possibility for the Government of being involved into the management of the foreign exchange assets has been removed. The grounds for dismissal of the members of the Governing Board of the Bank of Slovenia have been aligned with those mentioned in Article 14(2) of the ESCB/ECB Statute.

Other issues

A safeguard clause has been inserted into Art 12(1)2 BoSA as regards the possible role of the Bank of Slovenia as lender of last resort, so as to strengthen compliance with Art 101 EC and to avoid that the Bank of Slovenia might eventually end up bearing financial costs which are in principle to be borne by the state.

Timing

The legislative process has been completed. The Act amending the Bank of Slovenia Act entered into force on 14 April 2006. Arts 58 to 67b and Art 75 of the Bank of Slovenia revised Act will enter into force as from the date of the introduction of the euro in Slovenia.

3. PRICE STABILITY

3.1. Recent inflation developments

The downward trend in annual HICP inflation, which had been observed since mid-2001 continued until early 2005 at a rather stable pace. Annual average HICP inflation progressively declined from 8.6 percent in 2001 to 2.5 percent in 2005. Since the beginning of 2005, year-on-year inflation rates stopped declining and their volatility increased mostly due to the fluctuation of oil prices on the world markets. As a result, the pace of decline of the 12-month average inflation slowed down in the course of 2005. The 12-month average slightly rose in January 2006 on the previous month before declining again in February and March.

3.2. Respect of the reference value

The 12-month average inflation rate which is used for the convergence assessment progressively approached the reference value and reached it for the first time in November 2005. The 12-month average inflation rate was below the reference value since January 2006 with a progressively increasing margin. In March 2006 the reference value was 2.6 percent, calculated as the average of the 12-month average inflation rates in the three best-performing Member States (Sweden, Finland and Poland) plus 1.5 percentage points. The corresponding inflation rate in Slovenia was 2.3 percent, 0.3 percentage points below the reference value.

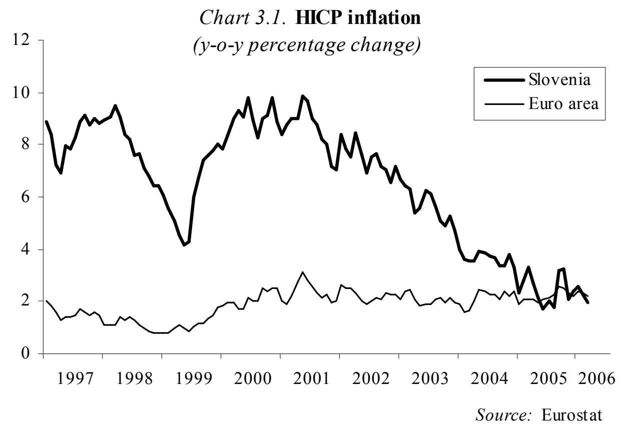


Chart 3.1. **HICP inflation**
(y-o-y percentage change)

Source: Eurostat

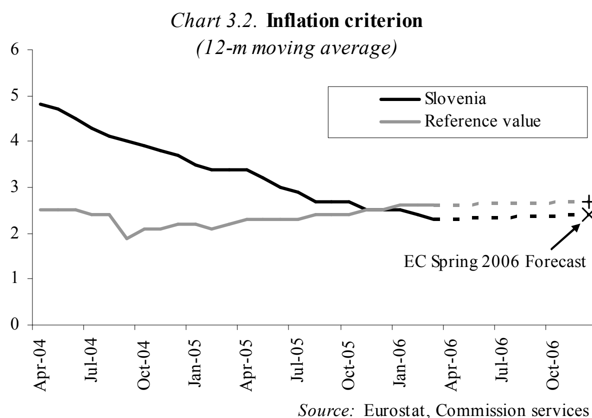


Chart 3.2. **Inflation criterion**
(12-m moving average)

Source: Eurostat, Commission services

Table 3.1.

Slovenia: Average inflation rate (HICP) and the reference value[1)]
(percentage change)

	December 2002	**December 2003**	**December 2004**	**December 2005**	**March 2006**
SI	7.5	5.7	3.7	2.5	2.3
Reference value[2)]	2.9	2.7	2.2	2.5	2.6

1) Measured by the arithmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices in the previous period

2) Unweighted arithmetic average of the three best performers in terms of inflation plus 1.5 percentage points; only EU-15 Member States are used in the period prior to May 2004.

Source: Eurostat, Commission services

3.3. Underlying factors and sustainability of inflation

With independence in 1991 Slovenia inherited a triple-digit inflation rate, which further increased in 1992. Through a policy based on money supply control, the newly created Bank of Slovenia succeeded to bring down inflation to double-digit levels since 1993. Inflation, as measured by the national CPI, has been below 10 percent since the end of 1996. The progressive disinflation trend was interrupted in May 1999, when year-on-year HICP inflation bottomed at 4.2 percent and quickly rose to close to 10 percent year-on-year by mid-2000. Main factors explaining this increase in inflation rates included the direct impact of the introduction of the value-added tax on 1 July 1999 with a standard rate of 19 percent; a large increase in oil prices on the world markets; and the opening of a large positive output gap in Slovenia in 1999. Monetary policy reacted by increasing policy interest rates from 9 percent for the lending rate at the beginning of 1999 to a peak of 12 percent in April 2001, while the fiscal policy stance became more expansionary.

Despite the fact that the base effect of the VAT introduction had mostly disappeared from the data by mid-2000 and that oil prices broadly stabilized in the course of that year, headline inflation remained steady and only started to decline since mid-2001. The main reasons for inflation persistency were an acceleration of the growth in unit labour costs principally explained by a double-digit wage growth in both 2000 and 2001; and an upward adjustment of administered prices, which contributed around 1.1 and 1.7 percentage points to headline inflation, respectively, in 2000 and 2001.

In November 2001, the Bank of Slovenia adopted a new medium-term monetary policy framework, principally aiming at decreasing inflation in line with the new primary objective of price stability and progressively stabilizing the exchange rate. The Bank also announced the objective to enter the euro area at the earliest possible date.

The initial stage of the disinflation process was helped by external factors, in particular by a progressive slowdown of imported inflation between 2000 and 2003. The development of imported inflation also benefited from a temporary slowdown of the annual pace of depreciation of the tolar-euro exchange rate in 2001.

Disinflation since 2003 has been underpinned by a coordinated policy approach of the Slovenian Government and the Bank of Slovenia based on an agreement concluded in November 2003 within the Joint Programme for ERM II Entry and the Adoption of the Euro. The main points of the agreement included the implementation of a progressive reform of the wage indexation mechanisms in the public and private sector; a commitment to control increases of administered prices to avoid that they contribute positively to inflation; increased pressure to improve efficiency in sectors naturally shielded from competition; progressive further stabilisation of the tolar-euro exchange rate in view of the expected ERM II entry soon after EU accession; and progress with fiscal consolidation. In addition, the central bank announced its intention to gradually decrease nominal interest rates to the euro area level, while at the same time signalling its willingness to support disinflation by maintaining an as-high-as-possible nominal interest rate differential vis-à-vis the euro area without generating overly strong nominal appreciation pressures.

The announcement and a rather rigorous implementation of these measures helped to anchor inflationary expectations of economic agents to the desired levels of inflation and the strong political commitment was an essential feature of the disinflation process in recent years.

Disinflation was further supported by a prudent policy mix in presence of a progressive opening of an important negative output gap between 2001 and 2003. The central bank lowered nominal interest rates as inflation slowed down since 2002, but real interest rates remained positive. The public finance stance supported the disinflation process in particular between 2001 and 2002 when, despite adverse economic conditions, the public finance structural deficit was cut from 4.6 percent to 2.1 percent of GDP, thus allowing the general government deficit to decrease despite the economic slowdown. While the slack in the economy helped to dampen demand pressures in the disinflation period, the progressive lowering of unemployment rates since 2003, in line with the economic revival, has not been associated with increased wage and price pressures, suggesting that the decrease in inflation is a structural rather than a cyclical phenomenon.

Table 3.2.

Slovenia: Components of inflation[1)]
(percentage change)

	2001	2002	2003	2004	2005	2006[2)]
HICP	8.6	7.5	5.7	3.7	2.5	2.3
Non-energy industrial goods	4.8	4.9	4.8	1.8	-0.3	-1.2
Energy	13.4	4.7	3.4	7.0	11.9	11.9
Unprocessed food	11.7	3.8	3.8	-1.4	-0.8	-0.6
Processed food	7.3	11.5	7.3	2.7	0.6	1.7
Services	10.4	10.2	7.1	5.8	3.3	3.1

1) Measured by the arithmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices in the previous period

2) Average of January-March 2006

Source: Eurostat and Commission services

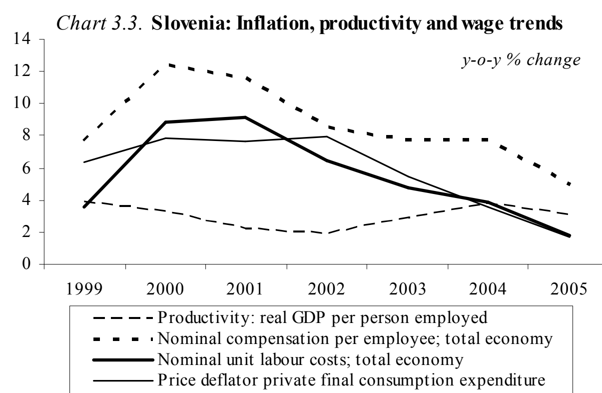
Wages and labour costs

The development of wages and unit labour costs in recent years reflected the overall commitment of social partners to the lowering of inflation. While unit labour costs in Slovenia strongly increased in 2000 and 2001 on the backdrop of a major wage increase in particular in the public sector, since 2002 the annual increase progressively eased, amid a marked slowdown of nominal wage growth and a progressive increase in the growth of labour productivity. Wage moderation in the private sector in the last two years was underpinned by the conclusion of a social agreement in April 2003 which, in a move to assist disinflation, foresaw a partial indexation of wages to EU along with domestic inflation and to the development of the euro/tolar exchange rate. Social partners agreed that real wages should lag productivity by 1 percentage point, which was effectively reflected in the pay policy agreement concluded for the period 2004-2005. This agreement was mirrored by a similar commitment to wage restraint in the public sector, which led to a lowering of nominal wage growth in the public sector from some 8 percent in 2003 to 1.7 percent in 2004 and to 3.9 percent in 2005.

Actual wage growth measured by nominal compensation per employee was higher than the minimum adjustments agreed by the social partners – at 7.7 percent in 2004 and an estimated 5.0 percent in 2005[16] –, but was lower than the average nominal wage growth of around 10 percent registered in the previous four years. As a result, also growth of nominal unit labour costs slowed significantly, reaching 3.8 percent and an estimated 1.8 percent in 2004 and 2005, respectively, compared with an annual average of 7.3 percent between 2000 and 2003. Apart from wage moderation, the lower growth of unit labour costs in the last two years also reflected the impact of an increase in the threshold for the payment of the tax levied on employees' wages (payroll tax) effective since 2004.

From a sectoral perspective, a gap between productivity developments in the manufacturing sector and the service sector together with broadly

Chart 3.3. **Slovenia: Inflation, productivity and wage trends**



Source: Commission services

comparable wage developments led to a large relative increase of unit labour costs in services over the last couple of years and fuelled inflation in this particular sector. While the disinflation process has also been visible in the services sector, further wage moderation and a continued search for higher efficiency will be key for price pressures in this sector to continue to ease.

[16] Data for compensation per employee for 2005 are not yet available. The growth of average monthly gross earnings in 2005 reached 4.9 percent.

Table 3.3.

Slovenia: Other inflation and cost indicators (annual percentage change)

	2001	2002	2003	2004	2005[1)]	2006[2)]
Private consumption deflator						
SI	7.6	7.9	5.4	3.5	1.6	2.2
EUR-12	2.4	1.9	2.0	2.0	1.9	2.1
Nominal compensation per employee						
SI	11.6	8.5	7.8	7.7	5.0	5.2
EUR-12	2.8	2.7	2.6	2.4	2.1	2.3
Labour productivity						
SI	2.2	1.9	2.9	3.7	3.1	3.7
EUR-12	0.5	0.4	0.6	1.7	0.9	1.3
Nominal unit labour costs						
SI	9.2	6.5	4.7	3.8	1.8	1.4
EUR-12	2.3	2.3	2.0	0.7	1.2	1.1
Imports of goods deflator						
SI	5.8	1.7	1.5	4.1	6.0	3.7
EUR-12	0.4	-2.9	-2.2	1.5	4.0	4.1

1) Nominal compensation per employee and nominal unit labour costs are estimates

2) Spring Forecast

Source: Commission services

Market functioning, domestic competition and EU accession

The disinflation process in Slovenia has been to some extent underpinned by a progressive improvement of the competitive environment as a result of a gradual liberalisation process, in particular in network industries. This has been visible for instance in a marked slowdown of the increases in prices of electricity and telecommunications in recent years. However, Slovenia is still lagging behind in the opening of some sectors to effective competition and in its effective enforcement (see chapter "additional factors").

More important for increasing competition and consequently for easing price pressures in a number of sectors was EU accession on 1 May 2004. Following the alignment of Slovene trade policies to EU standards, a number of products from both EU and non-EU Member States obtained easier access to the Slovene market. This contributed to a marked increase in trade, particularly visible in imports of goods from EU Member States, which strengthened competition on the domestic market with arguably permanent effects on price formation. This has been an important factor in the remarkable slowdown of price increases in traded goods after EU accession with the exception of oil-related energy products.

At the same time, some of the favourable effects of EU accession on inflation are likely to progressively fade out. This is the case of a very favourable development of prices of food and cars in the last two years, mainly explained by the abolishment of the remaining tariffs on imports from other EU Member States. As a result, prices of both food and used cars decreased markedly in 2005, bringing inflation down by around half a percentage point. While it is difficult to disentangle the precise temporary favourable impact on inflation from a more permanent effect of higher competition, it is likely that food and car prices will progressively start growing again, be it at a lower rate than in the past.

In addition, prices of traded goods in Slovenia benefited from a benign global environment in particular related to high competition from Asia. The largest contribution came from the segment of clothing and footwear, where high competition from China also related to the easing of trade conditions by the EU since the beginning of 2005 led to a drop in prices by 1 percent in 2005. To the extent that this segment has been directly influenced by a relaxation of trade restrictions in 2005, the favourable impact on inflation could also be considered as a temporary phenomenon.

External influences on domestic prices and changes to indirect taxation

Inflation in 2004 and 2005 was negatively influenced by the development of import prices of goods, which from an annual average growth of 1.5 percent in 2003 accelerated to 4.1 and 6.0 percent, respectively, in 2004 and 2005. As the nominal effective exchange rate contribution to imported inflation substantially decreased, in particular helped by the stabilisation of the tolar-euro exchange rate on ERM II entry in June 2004, the increase in imported inflation is explained by the strong surge in world commodity and in particular oil prices in the last two years. As a result, inflation of energy products accelerated from 3.4 percent in 2003 to 7 percent in 2004 and to almost 12 percent in 2005. Associated with a relatively high weight of energy in the Slovenian HICP basket, this increase led to a large positive contribution of energy to inflation in Slovenia in the last two years.

The impact of the movement of oil prices on domestic inflation has been mitigated by a regular adjustment of excise taxes on mineral oils implemented by the Slovenian Government since early 2003. As by July 2005 Slovenia reached the minimum level of taxes allowed by EU legislation, increases of oil prices have since then been fully transmitted into consumer prices. Calculations by the authorities show that the adjustments of excise duties in the last two years to March 2006 have lowered headline inflation by around 0.2 percentage points on average between March 2005 and March 2006. In addition to excise tax adjustments, the authorities have been smoothing the impact of fluctuations of oil prices by setting the market price for motor fuels in regular intervals,

which were extended from 14 to 28 days in October 2005. A comparison between developments of fuel and liquid oil prices in Slovenia and in the euro area shows very similar price movements and suggests that as level changes in oil prices have been broadly passed to consumers, no major pent-up price pressures should be expected from energy prices in the near future.

Concerning other indirect taxes, the introduction of the value-added tax in 1999 and an increase in the VAT rates to 8.5 and 20 percent in 2002 had a considerable one-off upward impact on headline inflation. At the same time, Slovenia has for several years been increasing excise taxes on cigarettes in regular six-month intervals. In line with the commitment made during EU accession negotiations to reach the minimum EU level by January 2008, tax adjustments will continue until this date. These excise tax increases have contributed to average HICP inflation by some 0.4 and 0.3 percentage points in 2004 and 2005, respectively. The remaining adjustments together with the carry-over of the effect on annual inflation of the increase from July 2005, will contribute around 0.2 percentage points in 2006 and 2007 and 0.1 percentage points in 2008.

The control of prices administratively determined by the government or other public authorities was a prominent feature of the Slovenian disinflation strategy since 2003. However, the surge in oil prices prevented the government from respecting its commitment to keep administered price growth in line with headline inflation. Energy-related administered prices (mainly passenger transport fuels and oil for heating) have considerably contributed to inflation in recent years, while non-energy related administered prices broadly grew in line with headline inflation.

Medium-term prospects

Inflation performance in 2006 will likely be the result of upward pressures stemming from an expected progressive increase of non-energy products price growth from the exceptionally low levels in the last two years and of the favourable effect of the expected somewhat lower average growth in oil prices on the world markets compared to 2005. As these two factors may broadly balance each other, inflation in 2006 is expected to stabilize at levels similar to 2005.

The large impact of specific factors on inflation in Slovenia in the last two years with a difficult-to-assess balance between one-off and permanent effects increases the uncertainty of any forecast. Notwithstanding this, the disinflation process in Slovenia has been driven by factors which could be expected to underpin a low inflationary environment in the medium term, including the reform of the wage-setting mechanisms associated with wage moderation, increase of competition, exchange rate stabilisation and fiscal consolidation.

At the same time, several upward risks to inflation can be identified. As euro area membership approaches, the effect of an expected opening of a small positive output gap in 2007 is likely to be further reinforced by a boost to domestic demand from the final convergence of interest rates and a release of liquidity resulting from euro area entry (see also section on exchange rate stability). An increase of the value-added tax rates in 2007, envisaged as a possibility in the 2006-2007 state budget to offset the revenue loss from the gradual abolishment of the payroll tax adds an additional risk to the inflation outlook. If implemented, the impact on inflation in 2007 could be as high as 0.7 percentage points. In the 2005 convergence programme the Slovenian authorities committed to continue to pursue fiscal consolidation and to achieve the medium-term objective of the revised Stability and Growth Pact by 2008. A more ambitious fiscal policy stance, however, would help to mitigate risks to inflation. In its opinion on the 2005 convergence programme, the Council called for "a more rapid progress towards achieving the programme’s MTO, especially by implementing the measures underlying the planned reduction of the expenditure ratio as well as by frontloading the adjustment effort".

The present low inflationary environment together with sound productivity growth should underpin a moderate development of unit labour costs in the near future. However, as the private sector pay-policy

agreement for 2006 and 2007 has not yet been achieved, uncertainties remain. The government has already signalled its intention to maintain wage moderation in the public sector for the immediate future. Such policy could have a strong signalling effect on the private sector and would help to ensure that real wage adjustments continue to support a low inflationary environment and competitiveness.

4. GOVERNMENT BUDGETARY POSITION

4.1. Recent budgetary developments

Over the 2000-2005 period Slovenia recorded an average public finance deficit of 3.0 percent of GDP, following three consecutive alignments of government accounts to the ESA95 methodology. The public finance deficit reached a high of 4.3 percent of GDP in 2001 after the general government expenditure had been revised upwards based on court rulings[17] on the recognition of war claims to be paid by the Restitution Fund.[18] The general government deficit dropped below the 3 percent of GDP threshold in 2002 and has progressively declined to 1.8 percent of GDP in 2005. Alongside a reinforced commitment to fiscal discipline, the decline of the deficit has been facilitated by an economic upturn.

In December 2001 Slovenia started adopting budgets for two consecutive years simultaneously, which seems to have encouraged fiscal prudence. Furthermore, to strengthen budgetary planning, the Implementation Bill attached to the 2004 budget gave discretion to the government to react to an unexpected revenue shortfall within the thresholds set in the bill by suspending new spending commitments. The mechanism was successfully applied in October 2004 to contain the negative fiscal impact of a substantial loss in VAT resources, following the dismantling of border controls after EU accession.

In 2005, the general government deficit reached 1.8 percent of GDP, well below the deficit of 2.1 percent anticipated in the January 2005 update of the convergence programme and in line with the initial target set in the May 2004 convergence programme. A supplementary budget for 2005 adopted in June 2005 featured a 20 billion tolar (approximately 0.3 percent of GDP) lower deficit compared to the initial target, after the new government had revised upwards the revenue projections and reviewed the composition of expenditures according to its new priorities. Revenues came in even better than expected, as the tax collection resulting from the new personal income and corporate income tax regimes, in force since 1 January 2005, had been underestimated and higher indirect taxes compensated for lower revenues from excise duties. General government expenditure was contained through a restrictive employment and wage policy in the public sector and a rationalisation of government purchases of goods and services.

Due to the October 2004 parliamentary elections, the parliament endorsed the 2006 budget only on 12 December 2005 with a general government deficit target of 1.8 percent of GDP, implying no deficit reduction compared to 2005. The European Commission Spring 2006 forecast foresees a slight increase of the deficit to 1.9 percent of GDP. Given that the effects of the anticipated structural reforms and the relevant features of the pending EU financial perspective could not have been included in the budget bill, a further amendment is expected. On the revenue side, the budget mainly includes further adjustments in the personal and corporate income tax and a decrease of the payroll tax rate by 20 percent, a first step towards its gradual abolition. On the expenditure side, the measures related to employment and wage policies that enhance cost effectiveness and flexibility will be partly offset by the decision to index pensions to wages adopted in May 2005. The structural deficit, which stood at 1.4 percent of GDP in 2005, is expected to deteriorate, to reach 1.8 percent of GDP, still below the minimal benchmark of 1.9 percent set in the Stability and Growth Pact for providing a safety margin against breaching the 3 percent of GDP reference value under normal macroeconomic fluctuations.

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[17] According to ESA95 rules, the recognition of liabilities by a court ruling should be recorded as expenditure (capital transfer, more specifically) at the time of the legal decision, irrespective of the timing for effective cash payment.

[18] The Restitution Fund is a government body for restitution of nationalised and confiscated properties to the original owners before the second world war and for compensation of damages to war and post-war victims.

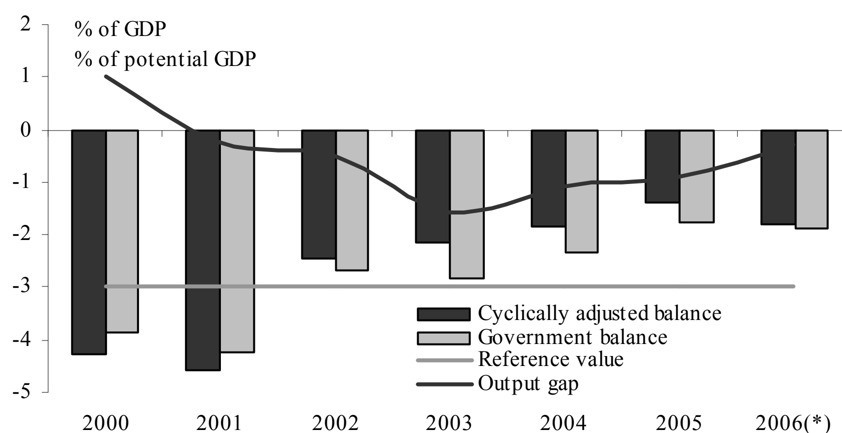
Table 4.1.
Slovenia: Budgetary developments
(as percentage of GDP unless otherwise indicated)

	2000	2001	2002	2003	2004	2005	2006(*)
General government balance	-3.9	-4.3	-2.7	-2.8	-2.3	-1.8	-1.9
- Total revenue	44.3	44.7	45.4	45.2	45.3	45.5	45.5
- Total expenditure	48.1	49.0	48.0	48.1	47.6	47.3	47.3
of which: interest	2.5	2.5	2.4	2.1	1.9	1.6	1.5
primary expenditure	45.7	46.5	45.7	46.0	45.8	45.7	45.8
GFCF	3.1	3.1	3.0	3.3	3.4	3.3	3.4
Primary balance	-1.4	-1.8	-0.3	-0.7	-0.5	-0.1	-0.4
p.m. Tax burden	38.9	39.1	39.5	39.7	39.9	40.1	40.1
Government debt	27.6	28.3	29.7	29.1	29.5	29.1	29.9
p.m. Real GDP growth	4.1	2.7	3.5	2.7	4.2	3.9	4.3
p.m. HICP inflation	8.9	8.6	7.5	5.7	3.7	2.5	2.4

(*) Spring Forecast

Source: Commission services

Chart 4.1. **Slovenia: Government balance and economic cycle**



(*) Spring Forecast

Source : Commission services

While structural efforts helped in containing the general government deficit in the period from 2001 up to 2003, when the output gap was widening, the deficit reductions in 2004 and 2005 were facilitated by the more favourable macroeconomic situation; the negative output gap is estimated to have narrowed from 1.6 percent of potential GDP in 2003 to below 1 percent in 2005.[19]

The gradual fiscal consolidation was accompanied by a progressive restructuring of general government revenues and expenditures in order to enhance budgetary flexibility. Revenues relative to GDP rose slightly between 2000 and 2005, coming from 44.3 to 45.5 percent of GDP. The expenditure ratio, on the other hand, inched down, from a peak of 49.0 percent of GDP in 2001 to 47.3 percent in 2005 mainly thanks to lower interest payments. The rigid regulatory framework constrains the speed of fiscal adjustment, as the share of mandatory spending amounts to more than three quarters of the overall outlays. The share of investment spending remained at around 3 percent of GDP, justified by the need to improve infrastructure and business environment in order to underpin the catching-up in economic level. The need to bolster competitiveness of the Slovene industry has prompted adjustments in the direct tax regime and the payroll tax, as a means to ease the tax burden on labour. Nevertheless, the total share of taxes and social contributions to GDP has been increasing since 2000 and is now some 40 percent, slightly above the EU average.

4.2. Government debt

The general government debt has been lingering at slightly below 30 percent of GDP since 2000. At the end of 2005, the gross debt accounted for 29.1 percent of GDP, down from 29.5 percent in 2004. In June 2005, the government repaid debt in the amount of 80.9 billion tolars (1.2 percent of GDP) by using the remaining privatisation proceeds from the sale of a minority share in the biggest Slovene bank, the Nova Ljubljanska Banka in 2002.

4.3. Medium-term prospects

The sustainability of the budgetary position is examined in the second update of the convergence programme, covering the period 2005-2008, submitted on 8 December 2005. The macro-economic scenario underlying the programme foresees real GDP to grow close to 4 percent and inflation to settle around 2.5 percent. The budgetary strategy over the medium-term is to gradually reduce the general government deficit to 1 percent of GDP. The programme announces tax reform measures, leading to a drop in the share of revenue as a percentage of GDP by 1.8 percentage points, and measures on the expenditure side, resulting in a decline in the expenditure ratio by 2.5 percentage points of GDP. Over the medium-term horizon, the general government debt is expected to stay below 30 percent of GDP.

The Council examined the updated convergence programme of Slovenia on 14 February 2006 and regarded the budgetary strategy, aiming at a steady and smooth fiscal consolidation over the programme period, as having set plausible targets. The risks to the budgetary projections in the programme were considered as broadly balanced. While budgetary targets had been relatively well met in the recent years, the high share of mandatory expenditure still awaits political consensus to be restructured in a more flexible way and thus exposes fiscal targets to an implementation risk. The Council further judged that the medium-term objective (MTO), set a structural deficit of 1 percent of GDP, was consistent with the revised Stability and Growth Pact. As the MTO was lower than the minimum benchmark (estimated at a deficit of almost 2 percent of GDP), a safety margin against breaching the 3 percent of GDP deficit limit seemed assured in each year covered by the programme. While the MTO was likely to be achieved by 2008, as planned in the programme, the planned adjustment towards the MTO fell short of the benchmark, set at 0.5 percent of GDP for euro area and ERM II Member States in the Stability and Growth Pact.

[19] The calculations of potential growth (and hence the output gap) must be treated cautiously as they are exposed to potentially considerable uncertainty particularly for countries experiencing a catching-up process.

Table 4.2.

Slovenia: Convergence programme projections for general government balance and debt (as percentage of GDP)

	2004	2005	2006	2007	2008
Balance	-2.0	-1.7	-1.7	-1.4	-1.0
Debt	29.5	29.0	29.6	29.8	29.4

Source: December 2005 convergence programme and Commission services

Moreover, Slovenia is considered to be at high risk as regards long-term sustainability, although government debt stands at only 30 percent of GDP. According to the current projections based on existing measures, Slovenia appears to be at high risk with regard to the long-term sustainibility of public finance due to a substantial rise in age-related expenditures. The parametric pension reform in Slovenia has already produced a positive budgetary impact since its entry into force in 2000 as the average retirement age has increased and the share of pension expenditure in GDP has declined. However, the favourable effects of the reform in containing pension outlays have been partially offset by the change in the indexation rule applied to pensions, adopted in May 2005.

The Council invited Slovenia to step-up the budgetary progress towards achieving the MTO, especially by frontloading the adjustment effort and to undertake measures to improve the long-term sustainability of public finances.

5. EXCHANGE RATE STABILITY

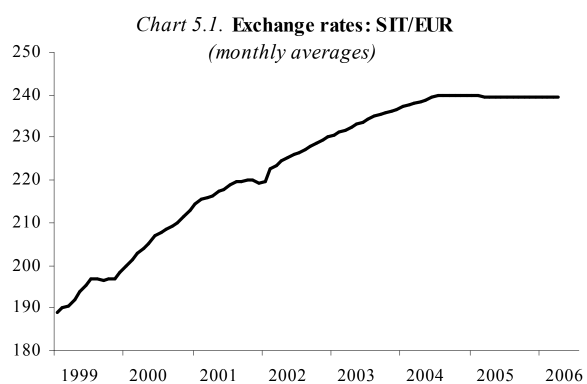
Slovenia entered ERM II on 28 June 2004 and has, by the time of the drafting of this report, so far spent 22 months in ERM II. Inside ERM II, the tolar-euro exchange rate has stayed close to the central rate with maximum deviations of 0.16 percent on the depreciation side and 0.10 percent on the appreciation side of the fluctuation band. The average absolute deviation of the tolar-euro exchange rate from the central parity in the period covered by this assessment was 0.08 percent.

Table 5.1.
Slovenia: Spread of SIT against the ERM II central parity
(in percent)

	Average	**Average of absolute values**	**Maximum**	**Minimum**	**Standard deviation**
ERM II[1)]	-0.01	0.07	0.10	-0.16	0.07
May 2004 - April 2006	0.02	0.08	0.45	-0.16	0.11

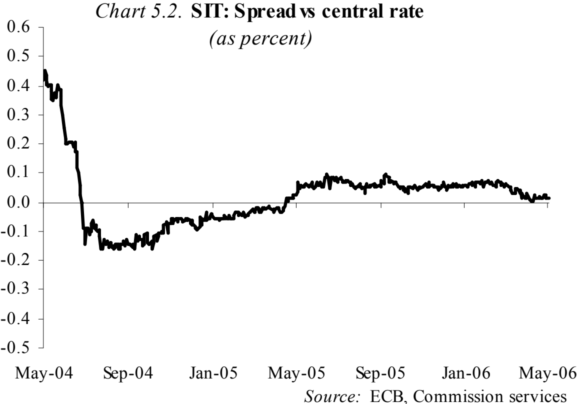
1) since 28/06/2004

Source: Commission services



Before ERM II entry, Slovenia had been using a de facto crawling peg exchange rate system, where the Bank of Slovenia had actively managed the exchange rate on a depreciating path in order to discourage interest sensitive capital inflows. Nominal depreciation was used as a tool to decrease the expected capital gains on foreign investments into tolar assets due to the prevailing positive interest rate differential with the euro area (uncovered interest rate parity). Between the introduction of the euro in January 1999 and April 2004, the tolar-euro exchange rate depreciated by some 26 percent, while the nominal effective exchange rate decreased by some 19 percent. At the same time, in line with the progressive decrease in the interest rate differential with the euro area, the ex-post annual pace of depreciation decreased from 5 percent at the beginning of 2003 to nil in June 2005, one year after the stabilisation of the tolar-euro exchange rate upon ERM II entry.

Chart 5.2. **SIT: Spread vs central rate**
(as percent)



Source: ECB, Commission services

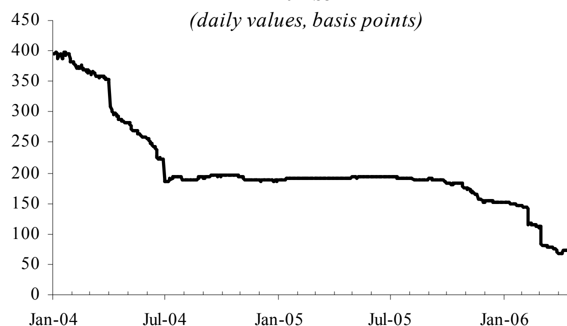
The ERM II central parity retained for the tolar corresponds to the market exchange rate on the last trading day before the decision on ERM II entry. As the policy of continuous tolar depreciation went on until ERM II entry, the tolar-euro exchange rate fell from 0.45 percent above the future central rate at the beginning of May 2004 to the central rate on 25 June 2004.

In the run up to ERM II entry, the Bank of Slovenia cut its main interest rates three times between April and June 2004, bringing down the interest rate on its main sterilization instrument – the 60-day tolar bill – from 5.25 percent to 4 percent on 17 June and the buy/sell swap rate from 2.5 to 1 percent at ERM II entry. This alignment of interest rates closer to the euro area level was accompanied by several public statements aimed at signalling a progressive slowdown of the intended annualized rate of depreciation of tolar from 2 percent at the beginning of April to zero at ERM II entry.

In line with the strategy towards ERM II and euro adoption published in November 2003, the authorities started to stabilize the exchange rate upon ERM II participation. The tolar-euro exchange rate slightly depreciated in the first days of ERM II participation and despite subsequent stabilisation and appreciation since October 2004, the tolar remained in the weaker half of the fluctuation band until April 2005. At the same time, the tolar stayed very close to the central rate and the maximum deviation on the depreciation side of the fluctuation band, hit several times between July and October 2004, was 0.16 percent. Since April 2005, the tolar has been moving in the stronger half of the band and gradually appreciated to its strongest level against the euro of 0.10 percent above the central rate reached in June 2005. The exchange rate stabilized since then and moved in a very narrow band of 0.03 and 0.10 percent vis-à-vis the central rate.

Exchange rate stability within ERM II has been achieved in the presence of a positive interest rate differential vis-à-vis the euro area for the whole period under examination. Given the permanent surplus of tolar liquidity on the Slovene inter-bank market, tolar money market rates in Slovenia closely reflect the interest rate applied on the main liquidity sterilisation instrument – the 60-day tolar bill of the Bank of Slovenia. This rate remained unchanged at 4 percent for most of the period since June 2004 and was only decreased recently by two subsequent 25 basis points interest rate cuts in February and March 2006. Consequently, the short-term interest rate differential vis-à-vis the euro area remained stable at slightly below 2 percentage points since July 2004 and decreased to below 1 percentage point only in recent months. At the same time, it is worth noting that the uncovered interest parity, which indicates the attractiveness of Slovenian short-term money market

Chart 5.3. **Slovenia : 3-M Sitibor spread to 3-M Euribor**



Source: EcoWin

instruments for foreign investors, increased at ERM II entry from 1 to 2 percentage points. The annualized intended short-term rate of depreciation of the tolar-euro exchange rate fell from an average of 2 percent in the first half of 2004 to 0 percent at ERM II entry, while the interest rate differential only decreased from around 3 to 2 percentage points. Together with a likely decrease in the risk-premium of Slovenian assets in ERM II, this differential helped to underpin the strength of the tolar.

Box 5.1: Exchange rate management in Slovenia

Exchange rate stability in Slovenia has been underpinned by an agreement concluded between the Bank of Slovenia and most of the commercial banks in 2001 and continued within ERM II. The agreement provides the participating banks with a standing facility for the temporary sale or purchase of foreign currency to the Bank of Slovenia with repurchase after seven days (swap) or the possibility to renew the contract at maturity. When commercial banks sell foreign exchange to the central bank, they pay a swap fee. This fee has been typically set in a way to close the gap between the ECB refinancing rate, the interest rate on the Bank of Slovenia tolar bills and a risk premium on tolar assets (and previously also the desired rate of depreciation of the tolar).

The official refinancing rate in Slovenia is formally set so as to equal the sum of the price of the buy/sell foreign exchange swap and of the ECB refinancing rate. In practice, however, foreign capital inflows helped to create a permanent liquidity surplus in the Slovene interbank market and made that liquidity-providing operations in tolars are not used. Instead, the participating banks have the possibility to obtain tolar liquidity by swapping their foreign exchange liabilities. They have been motivated to do so by the possibility not to have to respect the strict prudential rules for separately matching tolar and foreign currency denominated liabilities by assets of the same maturity and currency. Instead, for banks signatory to the agreement, the liquidity requirement holds for the sum of tolar and foreign currency denominated assets and liabilities, which is a substantially more flexible requirement. This relaxation was justified by the fact that the central bank, in the context of the swap arrangements, is committed to sell foreign currency upon simple demand to the participating banks and at the pre-agreed exchange rate. The risk of exchange rate depreciation has thus been transferred to the central bank.

To obtain this advantage, the participating banks committed to trade foreign currency on the foreign exchange market at the rate used in the transactions with the central bank. This rate can reflect the exchange rate determined by market forces, but can also deviate if the central bank wishes so. Given that most of the commercial banks have signed it, this agreement gives the Bank of Slovenia a close control of the tolar exchange rate. This possibility would, of course, be substantially reduced if fewer banks would participate in the agreement or if there were a significant market for tolar outside Slovenia, which is not the case.

The swap rate determines the cost for commercial banks to have access to tolar liquidity. As such, it can be seen as an indicator of the willingness of the Bank of Slovenia to influence the foreign exchange market. When the rate for exchanging foreign exchange for tolars with the central bank (buy/sell swap) increases, the central bank discourages commercial banks from using the swap instrument, while the lower the swap rate, the more automatic and cost-free window the banks have for obtaining tolar liquidity. Conversely, with an increasing sell/buy swap rate, which the central bank pays to the commercial banks when swapping tolars for foreign currency, the banks get easier access to foreign exchange.

The mechanism can be seen as a powerful tool to manage the exchange rate. At the same time, exchange rate pressures would still appear in changes in the swap rate; in fluctuations of central bank foreign exchange reserves (the net stock of swaps is part of the reserves) and in possible interventions; in large fluctuations of tolar-based monetary aggregates together with the stock of tolar bills issued by the Bank of Slovenia; and in the movement of interest rates combined with indications provided by balance of payments developments.

Ultimately, the mechanism would be unlikely to survive in case of a strong misalignment of the nominal exchange rate vis-à-vis an exchange rate preferred by the markets.

In case of strong depreciation pressures (overvaluation of the nominal exchange rate), commercial banks in search for foreign exchange liquidity would be unlikely to renew the buy/sell swap arrangements and ask instead for a higher sell/buy swap fee to be paid by the central bank. Ultimately, it would become too expensive for the central bank to run the system or it would run out of foreign exchange reserves. At the same time, such pressures would also be visible in a contraction of tolar-based monetary aggregates, since the central bank would have to buy tolars for foreign exchange.

As any fixed exchange rate system, the mechanism is better equipped to counter appreciation pressures. Still, to accept exchange rate stability in such a situation, the commercial banks would ask for free access to tolar liquidity. The central bank would either have to decrease interest rates to ward off the capital inflows potentially fuelling inflation pressures or increase its sterilization activity, the cost of which would eventually become prohibitive.

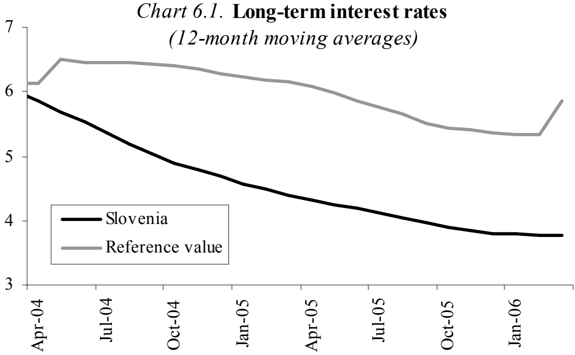
The development of the tolar-euro exchange rate has also been influenced by the agreement concluded between the Bank of Slovenia and most of the commercial banks on co-operation in interventions on the foreign exchange market *(Box 5.1)*. This particular system enabled the Bank of Slovenia to pursue a policy of continuous depreciation of the tolar prior to ERM II entry despite a quasi permanent excess of foreign currency inflows over outflows as reflected in a steady increase of the stock of foreign exchange reserves until end-2003.

The main feature of the system – the capacity of the bank of Slovenia to signal the desired exchange rate development – has been to some extent replaced by the signalling function of the central parity inside ERM II. The "price interventions" – when the central bank sets the base-exchange rate at which the commercial banks participating in the agreement are obliged to trade – have been used for the last time upon ERM II entry in order to signal to the market the intention to discontinue the depreciation and to henceforth stick to the ERM II central parity. The transition to the new exchange rate system within ERM II also required a temporary direct intervention in the foreign exchange markets and an adjustment in the swap rates to give banks easier access to foreign exchange liquidity. Following the stabilisation of the tolar in early July 2004, no further direct interventions have been necessary inside ERM II.

At the same time, the remarkable stability of the tolar-euro exchange rate has been supported through the use of exchange rate management instruments at the disposal of the Bank of Slovenia. Short-term volatility has been reduced through the foreign exchange swaps; and a compression of domestic interest rates in the presence of foreign exchange inflows was prevented by the issuance of central bank sterilization bills. In addition, the Bank of Slovenia decreased the reserve requirement on short-term tolar deposits in March 2005 from 4.5 to 2 percent to align with the ECB standards, but at the same time, commercial banks were obliged to place the released liquidity into long-term deposits with the Bank of Slovenia maturing only in March 2007. The non-renewal of these instruments at euro area entry or soon after is thus likely to temporarily boost liquidity of the domestic banking sector. The structural lack of liquidity in the euro area will absorb most of this liquidity release. Nevertheless, the existence of a possible home-investment bias together with the final convergence of nominal interest rates are likely to further ease monetary conditions in Slovenia at the beginning of euro area membership.

The evolution of additional indicators does not support the existence of major pressures on the tolar-euro exchange rate within ERM II. The diversification of portfolio investments towards foreign assets in the context of rapidly falling domestic interest rates in the first half of 2004 led to a temporary excess of demand for foreign exchange satisfied through the swap instruments and leading to a decrease of foreign exchange reserves of the central bank between April and July 2004. However, as foreign currency borrowing from abroad progressively accelerated with a built-in confidence in euro adoption and on the backdrop of the positive interest rate differential, the balance reversed in 2005 and, in spite of continuing portfolio investment outflows, the central bank had to absorb a large excess of foreign currency supply via its foreign exchange swap facility and through outright purchases into foreign exchange reserves. This has also been reflected in an increasing stock of issued tolar bills used to sterilize surplus tolar liquidity.

6. LONG-TERM INTEREST RATES



Long-term interest rates in Slovenia progressively declined from levels around 9 percent in mid-2002 and have stayed below 4 percent since January 2005. The progressive decline in long-term interest rates reflected a gradual decrease in inflation rates accompanied by a reduction in short-term policy rates and the decreasing country-risk premia linked to the fiscal consolidation and to the perspective of euro area accession. The spread vis-à-vis euro area average interest rates had been declining until ERM II entry in June 2004 and has since then remained between 10 and 70 basis points. The fluctuations of the spread mostly reflected the volatility of euro area long-term interest rates. At the same time, the remaining positive differential is explained by a lower liquidity of the secondary market in tolar denominated bonds and by the remaining currency risk premium incurred by foreign investors.

The Slovene 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion has continued to decline over the whole assessment period, largely reflecting a global decline in bond yields. The reference value for this criterion has been declining at a similar pace. In March 2006, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Sweden, Finland and Poland plus 2 percentage points stood at 5.9 percent. The twelve-month moving average of the yield on ten-year Slovenian benchmark bond stood at 3.8 percent, below the reference value.

Table 6.1.
Slovenia: Long-term interest rates
(12-month averages)

	December 2003	**December 2004**	**December 2005**	**March 2006**
SI	6.4	4.7	3.8	3.8
Reference value[1)]	6.1	6.3	5.4	5.9

1) Average of interest rates of the three best performing Member States in terms of price stability plus 2 percentage points

Source: ECB, Eurostat, Commission services

7. ADDITIONAL FACTORS

7.1. Financial market integration[20]

Slovenia's financial system has substantially integrated into the broader EU financial system. The main channel of integration has been increased external borrowing and investment, and foreign currency borrowing by corporations, while foreign ownership of financial intermediaries remains limited. Compliance with the *acquis communautaire* in the field of financial services was already broadly achieved on accession and good progress has been made in transposing the legislation adopted under the Financial Services Action Plan.[21]

The size of the financial system remains somewhat smaller than would be implied by the relatively high level of development of the economy.[22] The relative size of loans, debt securities and equity markets to GDP is broadly in line with the EU10 average but reaches only about one third of the EU15 average *(Chart 7.1).* Banks predominate among financial intermediaries. Insurance companies, investment funds, and leasing companies account for only about a quarter of total financial assets and pension funds are still at a very early stage of development.

Slovenia's financial system is quite concentrated, with a top five banks concentration ratio (CR5) of 65 percent in the banking and 80 percent in the insurance sector in 2004. While competition via cross-border services provided by other EU financial institutions is increasing, Slovenia's financial system is not fully privatised with a level of foreign ownership close to the euro area Member States but lower than in other new Member States *(Chart 7.2).*

Strong economic growth and convergence in interest rates have stimulated a progressive pick-up in the growth rate of bank lending to the private sector, notably to households *(Chart 7.3).* Following the withdrawal of remaining restrictions on domestic foreign currency lending in autumn 2003, corporations shifted from direct foreign currency borrowing abroad to domestic long-term borrowing in foreign currency (predominantly in euro). This shift in borrowing behaviour was fostered by the stabilisation of the euro-tolar exchange rate and aggressive euro-denominated lending activity by foreign banks. Accordingly, the share of foreign currency loans to household has also started to expand from negligible levels in 2003 to nearly 50 percent of new loans in 2005 *(Chart 7.4).*

Domestic lending growth has been to a large extent financed by external borrowing by banks and non-monetary financial institutions. On the other hand, there was also a sharp increase in institutional investment abroad. As banks' foreign currency liabilities and assets match relatively closely and at the same time banks reduced their exposure with the use of foreign exchange swaps of the Central Bank of Slovenia, the net exposure of financial intermediaries to exchange-rate risk is low, but the indirect exposure of banks to un-hedged foreign currency borrowing by clients is increasing.

The high level of investment abroad reflects the still relatively under-developed domestic securities markets. The debt securities market is dominated by central government bonds, which represent about 90 percent of outstanding issues. About one third of total outstanding debt securities are denominated in euro. Central government issues have been mostly denominated in Slovenian tolar since 2002 and have included a growing share of 10-year maturities. The number of actively traded companies on the Ljubljana Stock Exchange (LJSE) remains limited and includes no major financial institution. While the LJSE aims to

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[20] This section draws mainly on information provided by the Central Bank of Slovenia in its Financial Stability Report (June 2005) and Monthly Bulletins as well as a number of recent cross-country studies published by the ECB, the OeNB, the RZB Group and independent researchers.

[21] See: Transposition of FSAP Directives - State of play http://europa.eu.int/comm/internal_market/finances/docs/actionplan/index/memberstate_en.pdf

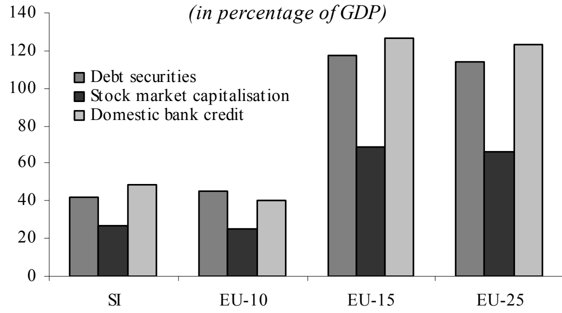
[22] Slovenia's GDP per capital level (PPP) is broadly comparably to Portugal, Greece, Cyprus and Malta

become more attractive to international portfolio investors, participation of non-residents is so far very low (i.e. less than 5 percent of holdings and turnover).

Even though the importance of financial conglomerates and branches is so far limited in Slovenia’s financial system, adequate supervisory structures will be essential in safeguarding financial stability as the financial system develops and becomes more integrated with the EU. Slovenia's three supervisory authorities – the Bank of Slovenia, the Securities Market Agency and the Insurance Supervisory Agency – have signed co-operation agreements among themselves and with a number of foreign supervisory authorities to increase the effectiveness of their activity. A consolidation of the various supervisory bodies into a single authority is being explored.

Chart 7.1. **Structure of financial system relative to EU10, EU15 and EU25 in 2004**

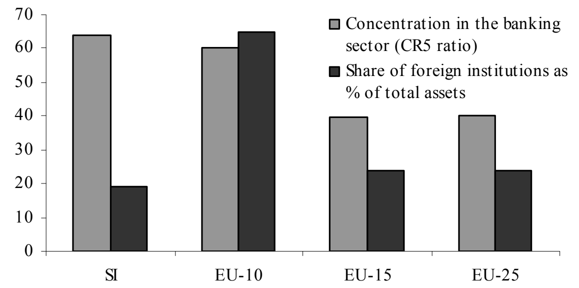
(in percentage of GDP)



Source : European Banking Federation, Eurostat, ECB, Commission services

Chart 7.2. **Foreign ownership and concentration in the banking sector in 2004**

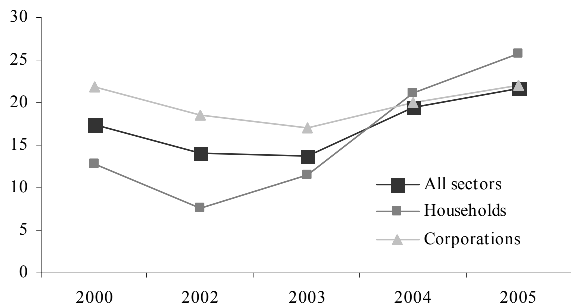
(in percent, weighted averages)



Source : ECB: EU Banking Structures (October 2005)

Chart 7.3. **Slovenia: Domestic credit expansion**

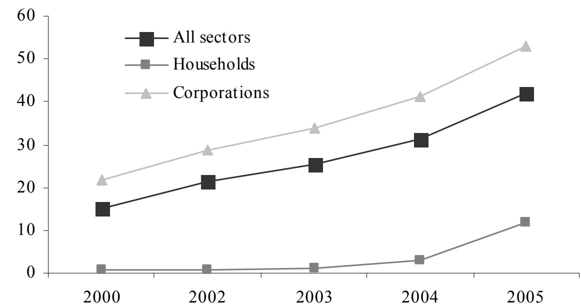
(y-o-y percentage change)



Source : Bank of Slovenia

Chart 7.4. **Slovenia: Share of foreign currency loans**

(percentage of domestic credit)



Source : Bank of Slovenia

7.2. Product market integration

Slovenia experienced a considerable structural change over the past fifteen years as it laid down the foundations of a market economy fully integrated in the EU. The Slovene economy is highly open to trade but has experienced rather modest foreign direct investment (FDI) inflows. Nonetheless, Slovenia is already, among the new Member States, one of economies whose industrial structure is more similar to that of the EU-15.

With respect to the creation of conditions for the smooth functioning of the Internal Market, Slovenia is lagging in the adoption and application of the body of Community legislation. Moreover, structural reforms aimed at improving the business environment and promoting higher levels of domestic competition appear to have stalled in recent years.

Trade and FDI

Trade flows are important catalysts for the real convergence to the EU average income level for a small economy like Slovenia. Trade integration allows the expansion of the production scale and the increase of competition levels leading to benefits in terms of efficiency upgrades. The Slovene economy is increasingly open to trade. The average degree of trade openness, measured as the ratio of average of imports and exports of goods and services over GDP was higher than that of the EU small Member States in the period 2000-2005. The other Member States are the dominant trading partners and their share in total trade is growing over time.

In 2001 the importance of labour-intensive industries matched that of capital-intensive sectors in terms of value added while in the EU as a whole the latter was 2.2 times larger the former. This suggests a specialisation in labour-intensive industries. However, in terms of technology intensity, Slovenia's industrial structure reveals important similarities to that of the EU. The main difference *vis-à-vis* the EU is the lower share of the medium-high technology sectors.[23] This sectoral profile of Slovenia's industrial structure explains the relatively high degree of similarity with export sectoral profile of the euro area.[24]

FDI inflows play a more limited role in Slovenia's economy than in other new Member States. The stock of inward FDI stock in Slovenia in 2004 (equivalent to 21 percent of GDP) was the lowest among the new Member States. The relatively low level of inward FDI in Slovenia is related to the privatisation process, which has been less intense and less receptive to the participation of foreign investors than in the other new Member States. The relatively low FDI inflows may have important medium-term consequences as the potential for technology, organisational and managerial skills transfers is more limited.

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[23] "Statistics in Focus - Industry, trade and services", no. 41/2004, Eurostat

[24] "Patterns of Trade, Delocalisation Choices and Catching-up", Luca de Benedectis and Lucia Tajoli, 2005

Implementation of the Internal Market

The low intensity of FDI may limit competitive pressures in the domestic market. In principle this can be overcome by promoting an adequate policy framework to ensure sufficient levels of contestability in the market. However, efforts have been limited so far in strengthening competition legislation and increasing the available resources to competition authorities. Moreover, Slovenia adopted a relatively gradual approach to structural reforms particularly with respect to liberalisation and privatisation. While some liberalisation has proceeded in network industries, incumbents are still dominant players. Sectors like telecoms and electricity as well as professional services remain relatively sheltered from competition. Furthermore, measures to improve the business environment have also lagged. In the 2005 World Bank survey Slovenia is ranked as the third worst performer in the EU with respect to the ease of doing business.

Further progress on the transposition and application of full body of EU-wide directives is important for the smooth functioning of the Internal Market in Slovenia. The Internal Market directives transposition deficit in December 2005 (1.2 percent) was only slightly below the EU average. Nonetheless this is a substantial improvement since 2004 when the country was clearly underperforming the rest of the EU.

Table 7.1.

Slovenia: Product market integration

	Slovenia						EU25					
	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
Trade openness [1] (%)	57.3	57.6	56.4	55.9	60.8	63.1(f)	36.2	36.0	34.8	34.3	35.5	36.7(f)
Extra-EU trade GDP ratio [2] (%)	12.9	13.3	13.3	13.5	13.7	-	10.2	9.9	9.4	9.2	9.6	-
Intra-EU trade GDP ratio [3] (%)	36.3	36.0	34.3	33.8	38.8	-	19.1	18.9	18.4	18.4	19.1	-
Intra-EU trade in services GDP ratio [4] (%)	-	-	-	5.7	6.1	-	-	-	-	4.6	4.7	-
Intra-EU trade balance [5]	-1.6	-1.4	-1.4	-1.7	-2.9	-2.4	84.5	104.2	115.0	97.3	77.9	79.9
Total FDI inflows GDP ratio [6] (%)	-	1.4	4.0	4.2	2.2	-		5.8	5.0	3.5	2.1	-
Intra-EU FDI inflows GDP ratio [7] (%)	-	1.3	2.5	1.7	1.9	-	-	4.3	3.7	2.3	1.4	-
FDI intensity [8]	-	0.8	1.5	0.9	1.4	-		3.9	3.7	2.5	1.7	-
Internal Market Directives [9] (%)	-	-	-	-	3.2	1.2	-	-	-	-	1.9	1.6
Price levels [10]	73.1	73.2	75.5	77.9	75.8	-	100	100	100	100	100	100

1) Average of exports and imports of good and service at current prices (national accounts) in percentage of gross domestic product at market prices.

2) (Extra-EU Imports+Exports/2xGDP at current prices)*100.

3) (Intra-EU Imports+Exports/2xGDP at current prices)*100.

4) Balance of payments: Intra-EU25 trade in services (average credit and debit in % of GDP at current prices).

5) Difference between export and imports in bn euros, based on monthly statistics.

6) Total FDI inflows as a % of GDP (at current prices).

7) Intra-EU Total FDI inflows as a % of GDP (at current prices).

8) Average value of Intra-EU25 inward and outward foreign direct investment flows, divided by GDP and multiplied by 100.

9) Percentage of Internal Market directives not yet communicated as having been transposed in relation to the total number.

10) Comparative price levels of final consumption by private households including direct taxes (EU25=100).

Source: Eurostat, Commission services

7.3. Development of the balance of payments

The Slovenian current account balance in 2005 recorded a deficit of 1.1 percent of GDP, down from 2.1 percent in 2004. While the trade balance deficit remained virtually unchanged at 3.8 percent of GDP, the services balance surplus increased from 2.6 percent in 2004 to 3.3 percent. The total of the income and current transfers' balances remained negative at 0.6 percent of GDP, with a negative contribution of the income balance and a positive contribution of the balance of current transfers.

Slovenia has a long tradition of a broadly balanced current account, principally reflecting a long-standing equilibrium between the deficit in trade in goods on one side and a surplus in trade in services together with a positive balance of current transfers on the other side. As an exception to this pattern, buoyant domestic demand led to a temporary deterioration of the trade balance in 1999-2000 pulling the current account into a deficit of 3.3 and 2.8 percent of GDP, respectively, in these two years. Subsequently, in line with the reversal of economic conditions, the current account rapidly improved and moved to a surplus or balance between 2001 and 2003. The current account deteriorated somewhat in 2004 as imports surged more than exports, partly as a direct effect of EU accession on 1 May 2004, which prompted a large surge in imports of food products from the EU Member States due the abolishment of the outstanding trade restrictions. As the current account deterioration was not fully matched by capital inflows, Slovenia recorded a decrease in reserves for the first time since early 2000. This was also linked to the surge in portfolio outflows since early 2004 after the lifting of remaining legal constraints on outward investments and a decrease in domestic interest rates.

However, the reversal since the second quarter of 2005 of the trend of a progressive deterioration of the balance of trade in goods and an accelerated improvement of the balance of trade in services in the same period contributed to a renewed decrease of the current account deficit in 2005. This trend also shows that the 2004 current account deterioration was most likely a temporary phenomenon and does not signal competitiveness problems for the Slovene economy or potential exchange rate pressures. Export growth in goods and services accelerated in both real and nominal terms during 2004 and remained robust in 2005 as well. This was in line with the gradual revival in Slovenian main trading partners and also with an improvement in cost competitiveness resulting primarily from more moderate unit labour cost and price developments in recent years.

Looking forward, the main challenge for Slovenia will be to safeguard a healthy competitiveness position, for which wage moderation will be essential. At the same time, despite a high domestic savings rate, Slovenia may have scope for a more extensive use of foreign savings for increasing domestic investment and productivity. While foreign borrowing has recently substantially increased, direct investment inflows remain modest, in particular compared with some of the other new Member States. At the same time, a significant contribution to domestic investment will come from EU structural funds, which will help to alleviate the external constraint without affecting Slovenian external indebtedness.

Table 7.2.
Slovenia: Balance of payments
(percentage of GDP)

	2001	**2002**	**2003**	**2004**	**2005**
Current account	0.2	1.5	-0.3	-2.1	-1.1
Of which: Balance of trade in goods	-3.1	-1.1	-2.2	-3.9	-3.8
Balance of trade in services	2.4	2.6	2.2	2.6	3.3
Income balance	0.2	-0.6	-0.7	-0.9	-0.8
Balance of current transfers	0.6	0.6	0.4	0.1	0.2
Financial and capital accounts	-0.7	-0.6	-0.1	2.4	2.6
Of which: Net FDI	1.1	6.5	-0.5	0.8	-0.1
Net portfolio inflows	0.3	-0.3	-0.9	-2.2	-4.4
Net other inflows	4.4	1.8	3.1	3.2	8.3
Net capital account	0.0	-0.7	-0.7	-0.4	-0.5
Change in reserves (+ is a decrease)	-6.5	-8.0	-1.1	1.0	-0.7
Errors and omissions	0.5	-0.8	0.4	-0.4	-1.5
Gross capital formation	24.1	23.4	24.7	26.3	25.3
Gross saving	24.3	24.8	24.4	24.4	24.5

Source: Eurostat and Commission services